

Essential Utilities, Inc.

WTRG: What's In A Name? - Change Ironically A Harbinger Of COVID Resiliency

Equal Weight/\$42

Water Utilities

Price Target Change

• **Key Points.** Management affirmed all aspects of guidance provided at the late February analyst day as WTRG's utility businesses are expected to be resilient to the challenges presented by COVID-19. It helps that the bulk of customers and revenues, for both water and gas, are residential and that the gas utility is past the high-demand heating season. In addition, constructive regulatory treatment of any incremental COVID-19 costs is expected. No change to our 2020-24E EPS of \$1.56, \$1.65, \$1.77, \$1.90 & \$2.02. Our outlook is consistent with management's 2020 pro forma (as if the Peoples deal closed 1/1 and experienced normal weather from 1/1 through the 3/16 close) EPS guidance of \$1.53-1.58 and 5-7% CAGR through 2022 off the '19 base. We reiterate our Equal Weight rating but lower our 12-18 month price target to \$42/sh (23.5-24.0X our 22E) from \$48/sh due to lower peer group multiples since our last update.

• **COVID-19 Impacts – Sales/Expenses.** Although it is early, management mentioned that preliminary April data shows that the increased residential usage is offsetting the decrease in C&I and gov't/public customers on the water side as the month came in right at budget. And with the heavy-use heating season over on the gas side, management does not see a material financial impact from usage but that could depend on how long the stay-at-home orders are in place. WTRG plans to track COVID-19 related expenses with an expectation that regulators will afford constructive recovery, particularly of bad debt expense given the implemented no shutoff policies for non-payment. Bad debt expense rose to 1.1% of revenues in the 2008-09 financial crisis which is about double the 0.5% that has been historically observed and embedded in water rates. That said, there are some costs that are lower which could help defray any increases. Net-net, the overall expense impact is not expected to be material.

• **COVID-19 Impacts – Capex/Liquidity.** In terms of capital deployment, a two week moratorium implemented on water work in PA did set the utility about \$30M behind schedule. However, the ground is expected to be made up over the balance of the year and there is no change to WTRG's overall water and gas capex budgets. Access to capital is not an issue. WTRG, like other utilities, have taken precautionary steps to boost near-term liquidity. The capex budget can be financed without equity but M&A deals will require some – we expect about 50% of the purchase price. With that in mind, we think WTRG could be flexible with the exact timing of the \$300M of equity needs outlined for later this year to finance DELCORA and other deals in the pipeline.

• Please see p. 2 for discussions of municipal M&A activity (spoiler alert, COVID-19 could increase the deal flow!), regulatory updates and a brief EPS & capex discussion.

\$	2019A	2020E	2021E	
EPS		Curr.	Prior	Curr. Prior
Q1 (Mar.)	0.28	0.60 A	0.62	NE
Q2 (June)	0.37	0.23	NC	NE
Q3 (Sep.)	0.48	0.25	0.24	NE
Q4 (Dec.)	0.34	0.47	NC	NE
FY	1.47	1.56	NC	1.65 NC
CY	1.47	1.56		1.65
FY P/EPS	27.5x	26.0x		24.5x
Rev.(MM)	890	1,927		2,058

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
 NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
 V = Volatile
 Adjusted EPS excludes items considered non-recurring.
 WTR expects 2020 adjusted EPS of \$1.53-1.58 and targets a 5-7% EPS CAGR through 2022 off the 2019 adjusted base of \$1.47

Ticker	WTRG
Price Target/Prior:	\$42/\$48
Price (05/07/2020)	\$40.49
52-Week Range:	\$30-55
Shares Outstanding: (MM)	220.8
Market Cap.: (MM)	\$8,940.2
S&P 500:	2,879.45
Avg. Daily Vol.:	900,670
Dividend/Yield:	\$0.94/2.3%
LT Debt: (MM)	\$3,077.0
LT Debt/Total Cap.:	44.1%
ROE:	9.0%
3-5 Yr. Est. Growth Rate:	6.0%
CY 2020 Est. P/EPS-to-Growth:	4.3x
Last Reporting Date:	05/06/2020
	After Close

NC = No Change

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

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Please see page 4 for rating definitions, important disclosures and required analyst certifications. All estimates/forecasts are as of 05/07/20 unless otherwise stated. 05/07/20 16:35:45 ET

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- **COVID-19 Impacts – Municipal M&A.** Similar to the thoughts expressed by AWK a few hours earlier, WTRG expects the volume of municipal M&A discussions/deals to be positively impacted by COVID-19. Many municipalities were already challenged financially and some even operationally (complying with increasingly stringent EPA standards) before the pandemic. The economic shutdowns have likely only exacerbated those pressures.

Management remains upbeat about the pipeline of deals, noted how a number of decent-sized opportunities have been advanced that can hopefully be talked about in the not so distant future and highlighted how fair market value (FMV) legislation continues to open doors. VA adopted FMV earlier this year – all 8 of WTRG's water states now have it – and deal momentum continues to build in other recently adopted states like OH & TX. Having closed on the Campbell, OH water deal earlier this year, WTRG has the New Garden, PA (\$30M), East Norriton, PA (\$21M) and DELCORA (\$277M) wastewater deals pending. The goal remains to achieve 2-3% customer growth through organic and M&A efforts.

- **Regulatory Updates.** WTRG's near-term regulatory calendar is fairly light as the PA water and gas utilities completed major base rate cases last year. The two proceedings of greatest investor interest are the DELCORA acquisition approval (filed in Q1; late '20 close expected) and PA regulatory treatment of the catch-up component of Peoples repairs tax deduction benefit (file this summer; clarity perhaps around YE'20; any retention by WTRG should be incremental to current outlook). Despite the challenges presented by stay-at-home orders, WTRG has not experienced any material regulatory timeline delays.
- **EPS Outlook.** Our 2020-24E EPS are \$1.56, \$1.65, \$1.77, \$1.90 & \$2.02. The core growth drivers remain (1) capex/rate base growth by aggressively reinvesting in existing systems and seeking timely regulatory recovery and (2) municipal M&A. 2020 capex remains \$550M for water and \$400M for gas with a total of \$2.8B budgeted over the 2020-22 period and we do not expect any falloff in those levels for the foreseeable future.
- In fact, an internally ordered report conducted by Black & Veatch to assess the overall safety of the Peoples gas system, including pressure risk, was completed earlier this month. While the conclusions were that the system is safe, WTRG is evaluating the recommendations made and preparing an action plan. There is an opportunity to invest more to further enhance safety and that will be addressed in future plans with an eye towards rate affordability.

Acronyms:

C&I – Commercial & Industrial

DELCORA – Delaware County Regional Water Quality Control Authority

Price Target

Price Target: \$42 from \$48

Our \$42/share price target reflects both a P/E multiple and DDM analysis. In terms of P/E, we apply a 70% water/30% gas utility hybrid multiple to our 2022E of \$1.77. For WTRG's water utility multiple, we ascribe a 5-10% discount to the 21E multiple we use for AWK (27.0-27.5X). The 5-10% discount reflects both a modestly lower EPS growth rate (we forecast 6.5% for WTRG vs. 8% for AWK) as well as lower ESG appeal (in particular, the recent Peoples deal). For WTRG's gas utility multiple, we utilize the 21E pure play gas LDC median of roughly 21X. Key risks include regulatory and M&A strategy execution related.

Investment Thesis

We are attracted to WTRG's strong fundamentals - a proven EPS growth strategy, a growing rate base, constructive regulation, efficient operations and a strong balance financial profile. Our Equal Weight rating reflects valuation considerations in light of WTRG's recently closed acquisition of Peoples (a gas utility) and the associated P/E multiple, regulatory and deal execution/integration related risks.

Company Description

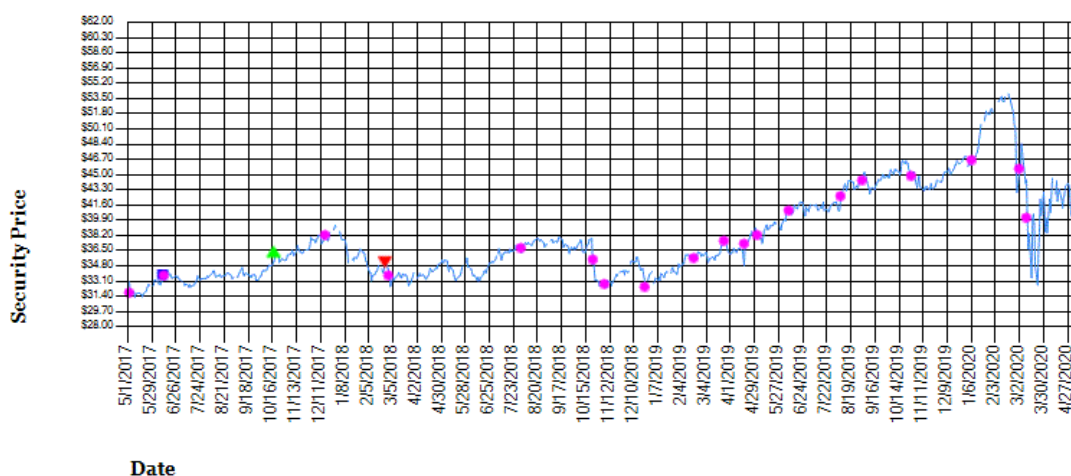
Headquartered in Bryn Mawr, PA, Essential Utilities (WTRG) - formerly Aqua America - is one of the largest U.S.-based investor-owned regulated water and wastewater utilities. The company serves approximately 3 million residents (1 million customer connections) in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, Indiana and Virginia. WTRG's largest subsidiary, Aqua Pennsylvania, accounts for approximately half of the company's total water customer base and nearly 70% of consolidated water rate base. Going forward, the company has expressed a desire to accelerate customer growth through a more active and focused acquisition strategy across its entire portfolio. Regulated operations account for more than 99% of consolidated revenues.

On 10/23/18, WTRG announced a deal to acquire Peoples - a predominately Pennsylvania-based gas utility serving 740k customers - from SteelRiver Infrastructure Partners for an enterprise value of \$4.275B (includes \$1.3B of assumed debt). From a price perspective, the deal appears to be 1.9-2.0X rate base, 14.8X EV/EBITDA and nearly 25X P/E - lofty multiples but not that dissimilar to what we have seen in recent gas utility transactions. WTRG received PA regulatory approval on 1/16/20 and the deal closed two months later on 3/16. Management expects the deal to be EPS accretive in the first full year after close (2020) but stressed this is a strategic-driven, not synergy-driven, transaction.

On 2/3, the new name Essential Utilities, Inc. and new ticker WTRG became effective. Prior, the company was known as Aqua America Inc. and traded under the ticker WTR.

Required Disclosures

Essential Utilities, Inc. (WTRG) 3-yr. Price Performance



Date	Published Price (\$)	Rating Code*	Price Target	Val. Rng. Low	Val. Rng. High	Close Price (\$)
5/1/2017		Kalton				
5/1/2017	NA	2	NE	31.00	33.00	32.94
5/4/2017	31.70	2	NE	32.00	34.00	31.73
6/13/2017		Reeder				
6/13/2017	33.62	2	35	NE	NE	33.62
10/19/2017	35.30	1	40	NE	NE	36.03
12/18/2017	38.14	1	43	NE	NE	38.03
2/25/2018	35.00	2	37	NE	NE	35.00
3/1/2018	34.19	2	36	NE	NE	33.66
8/2/2018	36.70	2	38	NE	NE	36.70
10/24/2018	35.01	2	37	NE	NE	35.29
11/6/2018	32.70	2	35	NE	NE	32.59
12/24/2018	33.87	2	34	NE	NE	32.38
2/19/2019	35.54	2	36	NE	NE	35.52
3/26/2019	37.52	2	39	NE	NE	37.52
4/18/2019	36.52	2	38	NE	NE	37.15
5/3/2019	37.85	2	39	NE	NE	38.09
6/9/2019	40.84	2	42	NE	NE	40.84
8/8/2019	42.06	2	44	NE	NE	42.47
9/2/2019	44.29	2	47	NE	NE	44.29
10/29/2019	44.90	2	46	NE	NE	44.68
1/8/2020	46.51	2	48	NE	NE	46.51
3/2/2020	43.01	2	45	NE	NE	45.44
3/11/2020	44.41	2	48	NE	NE	40.03

*Effective December 7, 2019, Wells Fargo Securities' Equity Research modified its ratings definitions. Complete definitions of current ratings can be found below. For information related to prior ratings definitions, please contact equityresearch1@wellsfargo.com.

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- Price Target/Val Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

- 1 Overweight/Buy
- 2 Equal Weight/Hold
- 3 Underweight/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

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WTRG: Key risks include regulatory and M&A strategy execution related.

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2=Equal Weight: Total return on stock expected to be 0-10% over the next 12 months. HOLD

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As of: May 7, 2020

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